3 October 2012

Don't Fight a Well-Armed Feisty Fed

- **The Fed has gone "all-out" but markets remain doubtful.** The decision to link the degree of monetary stimulus directly to the key measure of capacity utilisation (unemployment) is as aggressive as we have ever seen from the Fed. History shows that it has always been wrong to "fight the Fed" once it has decided to use whatever monetary stimulus is necessary to rectify a below capacity economy. Yet consensus expectations for US growth remaining at or below potential, alongside pervasive doubts about the efficacy of QE, indicate that the equity market is doubting the Fed's ability to succeed this time. On the one hand there are worries that efforts to create "artificially" low interest rates will lead to an inflation shock. On the other hand there are worries that in a "zero bound" deflationary world, the Fed has run out of "ammunition" and is therefore "pushing on a string", with QE only providing a temporary boost to asset prices and failing to stimulate the economy. So the question as to whether QE works has now become of paramount importance in considering the outlook for equity markets.

- **Interest rates are not artificially low, they are naturally low** and the very depressed level of bond yields in most of the major economies reflects market forces more so than central bank buying (Chart 1). Notions of "financial repression" and the inflationary consequences of an unusually low real Fed funds rate look to be well overdone. The Fed's job is not to pick an interest rate out of the air or to rob savers of a "fair return" but rather to set its official interest rate at the level that reflects the natural clearing rate that equilibrates desired savings and desired investment in the economy at any particular point in time, thus promoting full employment and price stability. In an environment where structural factors had already been dictating an unusually low clearing level for global interest rates, it makes sense to believe that the additional downward cyclical pressure on rates in the aftermath of one of the biggest ever economic downturns could justify a real Fed funds rate well into negative territory. Failure to deliver an appropriately low rate would amount to deflationary policy error and inflationary policy error would only occur if the real rate is kept inappropriately low as the economy moves back towards a more normal level of unemployment.

- **The essence of monetary policy has always been about controlling the real "risk free" rate and nothing has changed in this regard.** Until the recent downturn, the Fed had always been able to do this by adjusting the nominal level of its official interest rate to achieve the appropriate real level. However, the co-existence in recent years of structurally low inflation alongside a structurally (and cyclically) very low level for the natural interest rate has created the "zero bound" problem whereby the Fed's technical inability to push its nominal official rate below zero means that it loses its ability to control the all-important real rate to the downside once the zero nominal limit is reached. Once the zero bound is reached, the only way for the Fed to maintain downside control over the real official interest rate is through its ability to manage inflation expectations to the upside.

- **The essential purpose of QE is to manage inflation expectations to the level required to achieve the appropriate level of the real Fed funds rate when the zero bound for the nominal rate has been reached.** So, the answer to the question as to whether QE works is dependent on whether QE allows the Fed to control inflation expectations. All the evidence suggests that the Fed has been able to boost inflation expectations at will through its use of QE while also keeping such expectations on a rising track over recent years (Chart 2). So, although the nominal Fed funds rate has been flat-lining over recent years at the zero bound, the Fed has been able to manage the all-important real Fed funds rate lower (Chart 3). QE is often portrayed as an ineffective drug inducing only temporary relief and requiring bigger and bigger doses for shorter and shorter remission. However the analogy of a lifesaving medicine for which the dosage is still being perfected seems more appropriate.

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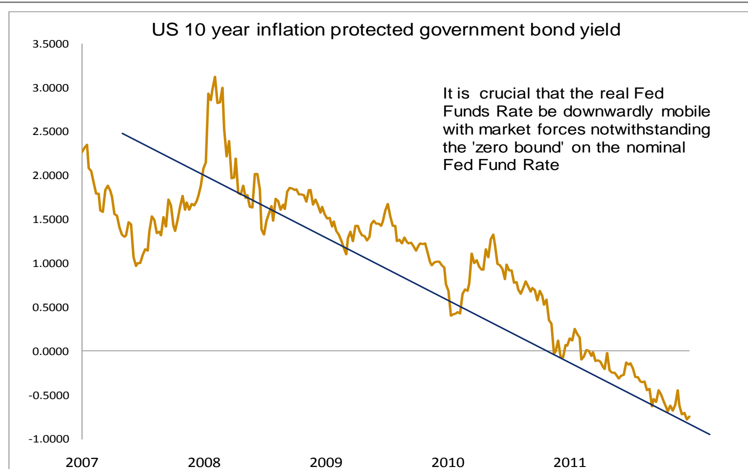
- **The balance of evidence already suggests that QE has in fact been working.** "Taylor rule" calculations are showing that whereas QE1 and QE2 etc. were entirely justified, the deflationary threat has already been largely seen off and that the current 0.25% nominal level of the Fed funds rate is now just about appropriate with no need for more QE to further boost inflation expectations (Chart 4). However, with the outlook for Eurozone and China increasingly clouded and with the local risk of inappropriate deflationary political deadlock in respect of the "fiscal cliff", the Fed remains on standby to make monetary policy yet looser, through pushing inflation expectations higher (while extending its commitment to a zero-based nominal rate), should the labour market fail to make satisfactory progress.

- **It makes sense for the Fed to play down the 2% inflation target while not abandoning it.** With the nominal Fed funds rate effectively zero-bound at 0.25%, market perceptions of a strict 2% inflation target (and related 2% inflation expectation) become problematic whenever the Fed judges that the appropriate level for the real Fed funds rate is lower than minus 1.75%. With 5-year inflation expectations currently around 2.2%, the real Fed funds rate is effectively in the region of minus 1.95% now. The Fed is practicing the art of maintaining enough "wriggle room" to maintain downside control of the real Fed funds rate through manipulation of inflation expectations (say between 2% and 3%), while at the same time not undermining its longer term inflation fighting credentials.

- **The Fed is leading global monetary policy** and other central banks like the ECB and the BOJ must inevitably follow or suffer inappropriate deflationary currency strength against the Dollar.

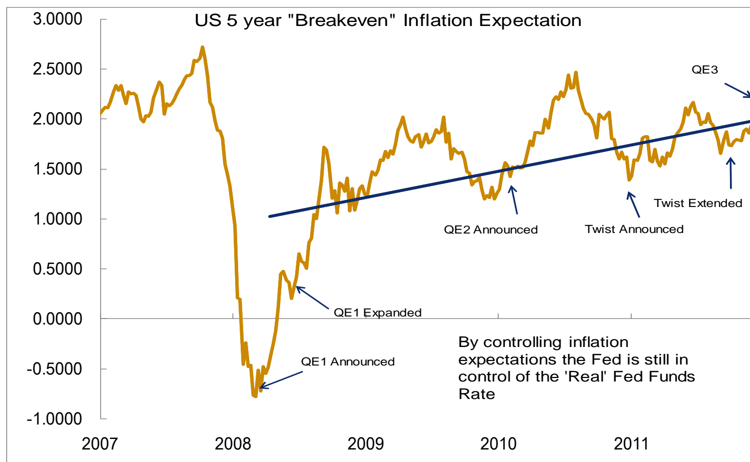
- **It is not different this time.** QE works. The Fed is fully committed and is not out of ammunition. The Fed is underwriting the ongoing global economic expansion and the related ongoing global cyclical bull market in equities (save for the impact of any unforeseeable geopolitical events). Don't fight a well-armed and feisty Fed.

Chart 1: Market forces have been driving real interest rates downwards



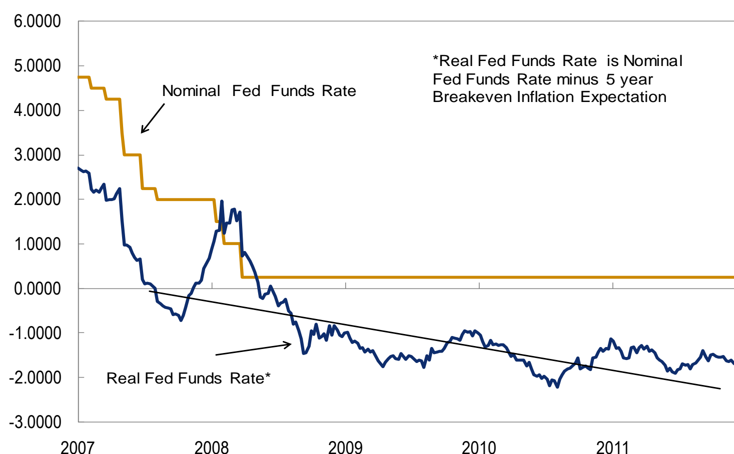
Source: Bloomberg, ESN

Chart 2: Controlling inflation expectations is Fed's main weapon in a 'zero bound' world



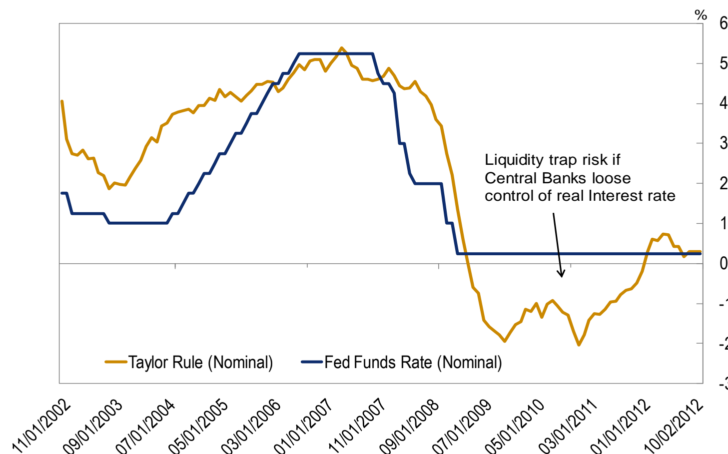
Source: Bloomberg, ESN

Chart 3: Fed is still in control of the 'Real' Fed Funds Rate



Source: Bloomberg, ESN

Chart 4: Q.E. has been working



Source: Bloomberg, ESN

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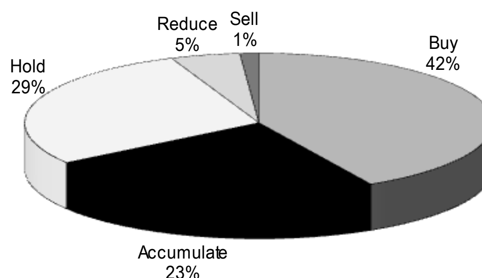

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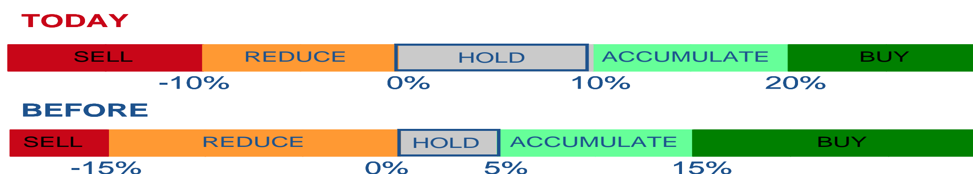

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